THE HOUSING FINANCE SYSTEM AND FEDERAL POLICY: RECENT CHANGES AND OPTIONS FOR THE FUTURE

The Congress of the United States
Congressional Budget Office

PREFACE

The system for financing the construction and purchase of housing has changed significantly in recent years. In the context of this still-evolving housing finance system, the Congress is now considering proposals to alter further the federal role. This paper, requested by the Subcommittee on Housing and Community Development of the House Committee on Banking, Finance, and Urban Affairs, describes recent changes in the housing finance system and analyzes options for further legislation. In accordance with the mandate of the Congressional Budget Office (CBO) to provide objective and impartial analysis, this paper contains no recommendations.

Wilhelmina A. Leigh of CBO's Human Resources and Community Development Division prepared this paper under the supervision of Nancy M. Gordon and Martin D. Levine. Numerous people at federal agencies--including the Federal Home Loan Bank Board, the Federal Home Loan Mortgage Corporation, the Federal National Mortgage Association, and the Government National Mortgage Association--and other organizations provided valuable information for the preparation of this report. Robert Buckley, Bernadette Caldwell, James Carr, Andrew Carron, Frank DeStefano, Diane Dorius, Julia Gould, Jack Guttentag, Thomas Hook, A. Thomas King, Warren Lasko, Warren Matthews, Barbara Miles, Robert Seiler, Cynthia Simon, Wilson Thompson, John Tuccillo, James Verdier, and Kevin Villani reviewed earlier drafts of the report and provided helpful comments. Many members of the CBO staff, including Roberta Drews, Alfred Fitt, Robert Hartman, Marilyn Moon, Larry Ozanne, Lisa Potetz, Frederick Ribe, Pearl Richardson, and Brent Shipp also contributed useful comments and necessary information. Francis Pierce edited the paper. Mary Braxton efficiently and painstakingly typed the many drafts and prepared the paper for publication.

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CONTENTS

CONTENTS (Continued)

TABLES

PAGE

SUMMARY

The housing finance system--the complex system of mortgage lending that enables buyers of houses to finance their purchases--is currently undergoing a transition. After operating as a highly regulated segment of the credit sector during a long period of relative economic stability, the housing finance system was jolted in recent years by rising interest rates. The federal response has been to ease the regulations that formerly governed mortgage lenders, reducing the insulation of housing finance from broader credit markets. Issues now arise as to whether further changes in federal policy might smooth the ongoing transition, and what the government's future role ought to be in the allocation of credit to housing.

DEVELOPMENT OF THE HOUSING FINANCE SYSTEM

The present housing finance system developed over the past half-century through a series of changing federal policies. These policies had to do with the regulation of private lending institutions, the issuance of mortgage insurance and other services, and tax provisions affecting housing.

The Early Years

Federal intervention in the housing finance system began in the 1930s in response to the widespread defaults and foreclosures that occurred during the Depression. Initially, the government offered federal charters to the existing private savings and loan associations and gave them the mission of providing funds for mortgage loans. It also insured their deposits, thereby encouraging savers to place their funds in mortgage lending institutions. Also, mortgage insurance programs were instituted to reduce the risk faced by lenders in making mortgage loans.

These policies, together with previously enacted federal income tax provisions allowing homeowners to deduct mortgage interest and property tax payments from taxable income, contributed to a sharp rise in homeownership--from 48 percent to 63 percent of all households between 1930 and 1970. They also resulted in a system of mortgage finance characterized by long-term, fixed-rate mortgage loans provided mainly by savings and loan associations and mutual savings banks out of funds in their short-term deposit accounts.

Recent Developments

This system operated well for many years, but by the middle of the 1960s rising interest rates and policy responses to them began to create difficulties. Higher interest rates on short-term deposits at mortgage lending institutions led to higher mortgage interest rates. To hold down interest expenses for the major mortgage lending institutions the federal government in 1966 established an interest rate ceiling on their deposit accounts. The limit was set higher than a comparable ceiling governing accounts at commercial banks to give mortgage lending institutions an advantage in attracting the deposits of small savers. Although the ceiling was increased gradually, depositors withdrew their money from the mortgage lending institutions at times when interest rates on other investments rose well above the cap.

During the late 1960s and early 1970s, in part to help mortgage lenders replenish their loanable funds, the federal government expanded its role in the "secondary" mortgage market through which lenders sell mortgages or mortgage-backed securities (MBSs) to investors. In 1968, an existing agency--the Federal National Mortgage Association (FNMA)--was partitioned, creating a tax-paying, federally chartered quasi-private FNMA with a line of credit to the U.S. Treasury, and a new government agency, the Government National Mortgage Association (GNMA), which guaranteed privately-issued MBSs backed by government-insured or -guaranteed mortgage loans. The government also established the Federal Home Loan Mortgage Corporation (FHLMC)--a publicly managed corporation under the aegis of the Federal Home Loan Bank Board and capitalized through the sale of stock to the Federal Home Loan Banks--to facilitate secondary market transactions for the savings and loan associations. These secondary market agencies have expanded the sources of credit for housing by transforming mortgage loans into more liquid and more marketable instruments, thereby enhancing the efficiency of the housing finance system.

Although the programs of these credit entities fostered an active secondary market in mortgages during the 1970s, they did not redress the problems mortgage lending institutions had in attracting and holding deposits. What is more, with interest rates continuing to rise through the 1970s, and with rates paid on deposits by savings and loan associations approaching the yields on their portfolios of fixed-rate long-term mortgages, mortgage lending institutions began to find their profitability threatened in the early 1980s.

The federal government responded to these problems by partially deregulating federally chartered depository institutions in several steps. First, mortgage lending institutions were allowed to pay market-determined interest rates on selected deposit accounts to help them compete for funds, and they were authorized to offer adjustable-interest-rate mortgages to help them match their investment returns with their interest expenses. Subsequently, their lending authority was broadened to cover a wider range of assets other than residential mortgages, and incentives provided through the tax system for them to invest in residential finance were reduced.

Even with deregulation initially exacerbating the profit squeeze for mortgage lenders because their cost of funds rose more rapidly than the yields on their investments, the longer-run effect has been to integrate more fully the housing credit sector with broader credit markets. Although savings and loan associations continue to originate more than one-third of all new mortgages, they now sell a high proportion of them in the secondary market, often through the federally sponsored credit entities operating there. As a result, depository institutions now provide a smaller proportion of all net additional mortgage credit, while other sources--mainly investors in mortgage pools--provide an increasing share.

ISSUES AND OPTIONS

Two issues now arise regarding future federal housing finance policies. The first is how to increase the efficiency of the housing finance system. Although recent market and policy changes have lessened the insulation of the housing credit sector, impediments may remain that increase the cost of the mortgage lending process. A second issue is whether adjustments are warranted for the present system of federal subsidies to housing--to reduce the overall advantages of housing compared with other investments such as business plant and equipment, and/or to make it easier for low- and moderate-income households to afford housing in a high-interest-rate environment.

Increasing Market Efficiency

Numerous proposals have been made recently to increase the efficiency of the partially deregulated housing finance system. Specific options reflect differing views regarding the net impact of present federal policies, but none would involve returning to the highly regulated system of the past. Also, while some actions might improve the efficiency of the housing finance system, housing would remain a highly cyclical sector of the economy, since it is necessarily sensitive to interest rate fluctuations.

Expanding Federal Housing Credit Activity. One set of options would involve expanding federal mortgage insurance or secondary market programs to cover certain credit subsectors that are not now served, because they developed or expanded only recently, after federal programs were already in place.

--Expand eligibility of alternative mortgage instruments for federal insurance and guarantees. Expanding the types of mortgage instruments eligible for insurance or guarantees under the programs of the Federal Housing Administration (FHA) and the Veterans Administration (VA) could facilitate mortgage lending. Although depository institutions offer many alternative mortgage instruments, the FHA insures and the VA guarantees only those that vary the payment schedule in a predetermined way. Expanding eligibility to include mortgages with interest rates adjusted to match the market over the term of the mortgage could encourage lending institutions to make more such loans, in part because the loans would then be eligible for purchase or pooling in federal secondary market programs. Such a change would increase the contingent liability of the federal government, however, and, given apparent resistance by borrowers to variable rate mortgages, would probably have little effect on the total supply of mortgage credit.

--Expand the secondary market in existing instruments. Another option would be to expand the types of mortgages eligible for purchase by, or pooling in, programs operated by the federal and federally sponsored secondary mortgage market agencies. Examples include loans for manufactured housing and cooperatives, second mortgage loans, and loans insured by state housing finance agencies. Expanding eligibility to encompass these mortgages might significantly affect certain housing submarkets, but would probably have little effect on the average cost of all housing credit.

Similarly, the federal government could raise the limit on the value of mortgages purchased under programs of federally sponsored credit agencies --currently $108,300 for a loan on a single-family home. This would expand the market penetration of these programs but could supplant the activity of private-sector institutions currently operating in the market for large mortgages.

Encouraging Housing Credit Activity by the Private Sector. Another approach would be for the government to encourage private-sector housing credit activity by removing statutory or regulatory impediments to the issuance of private MBSs that are backed by pools of conventional mortgages--that is, mortgages neither insured nor guaranteed by a federal agency. Although several impediments to the development of private conventional MBSs have been eliminated recently, one major hindrance remains--the provisions of the federal tax code under which mortgage-backed securities, unlike corporate securities, are subject to taxation both at the level of the holder of the security and at the level of the party managing the pool of assets backing the MBS. This double taxation can be avoided only if MBSs are passively managed; however, to maximize profitability, MBSs must be actively managed, involving, for example, the substitution of new loans for prepaid ones and the reinvestment of principal payments.

Amending the federal tax code to do away with double taxation of actively managed privately issued MBSs would eliminate a disadvantage they now suffer compared to privately issued nonhousing securities, which are taxed only at the shareholder level. This could do a great deal to encourage the use of privately issued conventional MBSs, which might in turn increase investment in mortgages by a greater number of credit sources, particularly pension plans. On the other hand, depending on how issuing requirements were structured, amending the federal tax code could induce some smaller securities issuers to undertake a new activity for which they might not be adequately prepared. Also, to the extent that such a change increased the overall flow of capital to housing, it would divert investments into a sector of the economy that already enjoys many advantages provided through the federal tax system, unless these advantages for housing investment are modified.

Reducing Direct Federal Housing Credit Activity. A third approach that has been suggested is to reduce federal mortgage insurance or secondary market programs in the hope of stimulating the development of private-sector alternatives. Proposals of this sort reflect the view that federal programs impede the efficient operation of the market by discouraging the private sector and do not lower mortgage interest rates significantly. But if the federal government withdrew, there is no assurance how quickly private institutions would or could fill the void. Therefore, any sharp reduction in the federal role might seriously impede the operation of the housing credit sector in the short run. Cutting back federal activity only gradually or only for selected submarkets would reduce but not eliminate this risk, and might raise mortgage rates slightly in the long run.

Altering Federal Subsidies

Regardless of what changes might be made to improve the efficiency of the housing finance market, the Congress might want to address the related issue of the role of subsidies to housing--particularly those provided through the tax system. Here, two quite different concerns arise. First, despite substantial existing subsidies, low- and moderate-income households find it increasingly difficult to afford to purchase housing in the current high-interest-rate environment. On the other hand, the recent decline in productivity growth has raised concerns that the United States may be allocating too much capital to housing at the expense of other sectors of the economy.

Several changes could be made in federal tax provisions to target subsidies on households that would otherwise find it difficult to afford to purchase homes. Specific options include: extending a more targeted version of tax-exempt revenue bonds to finance single-family mortgages beyond the currently scheduled expiration date of December 31, 1983; establishing a partial tax credit for mortgage interest payments in addition to, or in place of, the deductibility of such payments from taxable income now available to homeowners who itemize; and authorizing tax-subsidized savings accounts to make it easier to accumulate funds for a down payment. These changes would aid those homebuyers who now benefit least (or not at all) from current tax subsidies, but at the expense of larger revenue losses to the government. Repealing the "sunset" on mortgage revenue bonds, for example, could increase federal revenue losses by $2.8 billion over the fiscal year 1984-1988 period.

Other changes could be made to reduce untargeted subsidies for housing--either as a means of financing greater targeted subsidies, or independently, as a means of encouraging the flow of capital to areas of the economy other than housing. One option would be to establish a ceiling on the deductibility of mortgage interest payments from taxable income, or to allow only a fixed proportion of interest payments to be deducted. Such a change would raise the after-tax costs of homeownership for some owners who itemize deductions. While it could be designed to concentrate adverse effects on those in the best position to bear them, it would be difficult to avoid treating similar households differently, because the additional tax burden would depend, among other things, on when the house was bought and, therefore, the interest rate on the mortgage.

Another approach would be to modify favorable tax treatments now available to savings and loan associations and mutual savings banks that invest certain proportions of their assets in mortgages. Such a change would reduce the incentives that these institutions now have to provide funds for mortgages, thereby possibly diminishing the supply in the long run. To the extent that the total supply of mortgage funds was reduced, this approach could also result in somewhat higher mortgage interest rates, while reallocating funds from housing to other sectors of the economy.

CHAPTER I. INTRODUCTION

The housing finance system is currently in a state of flux resulting from changes in the economy and in federal policy. Economic changes, particularly high inflation and interest rates in the recent past, have altered the terms on which housing credit is made available. Federal policy changes--the deregulation of federally chartered financial institutions and changes in the programs of federal and federally sponsored credit agencies--have also affected the housing finance system. The result has been to break down the institutional barriers between housing finance and the broader credit markets, so that housing now competes for funds on a more even footing with other types of investment. This in turn raises issues relating to the continuing federal role in the housing credit system. 1/

THE EXISTING HOUSING FINANCE SYSTEM

The existing housing finance system provides credit through both primary and secondary mortgage markets. The primary market provides funds for mortgage loans, and these loans or securities backed by them are sold in the secondary market. A buyer unable to pay cash for a home obtains a mortgage loan to finance the difference between the purchase price and the down payment. The mortgage loan is typically repaid in monthly installments of principal and interest over a period of up to 30 years. In 1982, approximately $1.1 trillion in mortgage loans on one- to four-unit houses was outstanding, accounting for 20 percent of all private credit outstanding.

A number of institutions and individuals--functioning as lenders, investors, or borrowers--make transactions in the primary and secondary mortgage markets. The major mortgage lenders in the primary market are depository institutions--savings and loan associations and mutual savings banks (together known as thrift institutions), and commercial banks, all of which obtain funds from their despositors. Depository institutions provided

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1. This paper focuses primarily on the finance system for single-family --that is, one- to four-unit--housing. Although the credit markets for single-family and multifamily housing are intertwined in some respects, there are major differences in the way these types of structures are financed.

two-thirds of the $95 billion of newly originated residential mortgage loans on one- to four-unit houses in 1982. Other lending sources include mortgage bankers, life insurance companies, and individuals selling their homes. The borrowers in the primary market are the households who purchase homes with mortgage loans from these sources. The investors are primarily the stockholders and depositors in the depository institution.

In the secondary mortgage market, individuals and institutions that originate mortgages sell them to investors either as mortgages or as securities backed by pools of mortgages. It is through this market that such sources of capital as pension plans may invest in mortgages, becoming an indirect source of housing credit. The secondary mortgage market may help to lessen somewhat the cyclical instability of the housing market by expanding the sources of funds. However, sizable swings in the volume of home purchases and residential construction with changes in interest rates remain an inherent part of the housing sector, for two reasons. First, the net costs of home ownership vary so greatly with interest rates. Second, a home purchase is a postponable decision.

Federal activity in the housing finance system is intended to increase the efficiency of the housing credit market--that is the pairing of potential lenders, or investors, and borrowers at the lowest possible cost. The federal role includes the regulation of the major primary market lenders, the issuance of insurance and guarantees on privately written mortgages, and the operation of agencies that facilitate transactions in the secondary mortgage market. Federal tax provisions also have an impact on the flow of funds toward housing by lowering its after-tax cost to homeowners and increasing its attractiveness as an investment.

PLAN OF THE PAPER

The remainder of this paper describes recent changes in the housing finance system and presents options for altering the federal role. Chapter II discusses the development of the housing finance system and current issues that have been raised about it. Chapter III describes existing federal housing finance policies and programs in more detail. Chapter IV examines recent market and federal policy changes and resulting shifts in the sources, forms, and cost of mortgage credit. Chapter V presents policy options intended to increase the efficiency of the housing finance system or to alter federal subsidies for housing finance.

CHAPTER II. THE DEVELOPMENT OF THE HOUSING FINANCE SYSTEM AND CURRENT ISSUES

Federal policies toward housing finance have changed over the years with changes in economic circumstances. Although a principal concern has always been to increase the efficiency of the mortgage market, other objectives have also been pursued. In the years immediately following the Depression, policy focused on stabilizing the housing sector to help stabilize the economy. The system that evolved--which featured long-term fixed-rate mortgages provided primarily by highly regulated depository institutions--generally operated efficiently until the inflation and high interest rates of the last two decades jolted both the economy and the housing sector. Recent federal policy changes have resulted in the partial deregulation of mortgage lending institutions and the increased integration of the housing finance system with broader credit markets. These policy adjustments, and the economic circumstances that gave rise to them, now raise issues concerning the future direction of federal housing finance policy.

This chapter first traces the development of the housing finance system, including the changing federal role, and then presents issues now confronting the Congress.

EARLY DEVELOPMENT OF THE HOUSING FINANCE SYSTEM

The federal government began to intervene in the housing finance system in the 1930s in response to widespread mortgage defaults and foreclosures resulting from the Depression. It extended charters to the existing system of private depository institutions known as savings and loan associations, which had been established to provide mortgage loans for their depositors. 1/ The government also undertook to insure the deposits of the

1. Mutual savings banks, chartered by the states since 1816, had the primary mission of providing consumer credit. In the early 1950s, the federal government removed the tax exemption of both savings and loan associations and mutual savings banks and established a bad debt reserve deduction to encourage investment in residential mortgages by both types of institutions. See Chapter III for a more detailed discussion of private lending institutions and their regulation.

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recently chartered mortgage lending institutions, and to provide insurance or guarantees for privately written mortgages. 2/

Because deposit and mortgage insurance established the federal government as recourse for losses arising from the mortgage lending process, savers were encouraged to place their funds in the mortgage lending institutions, and lenders faced reduced risks in making mortgage loans. These forms of insurance may have contributed to lower mortgage interest rates than would otherwise have prevailed, thus lowering the before-tax cost of housing. In addition, tax provisions established before the Depression lowered the after-tax cost of housing--principally by allowing homeowners to deduct mortgage interest and property tax payments from taxable income. The importance of these provisions increased over time as marginal tax rates rose, because taxpayers with high marginal tax rates benefited most from them.

Taken together, these policies had several effects. For one, federal intervention in the housing finance system contributed to a sharp rise in homeownership--from 48 percent to 63 percent of all households between 1930 and 1970 alone. 3/ At the same time, the increasing use of the tax provisions that lower ownership costs meant high revenue losses for the federal government. In 1970, for example, the federal revenue loss from the deductibility of mortgage interest on owner-occupied homes was $2.8 billion, and the loss from the deductibility of property taxes on owner-occupied homes was $2.9 billion. 4/

Another result of federal intervention was to help standardize the mortgage loan instrument and the system for financing it. The system that

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2. The Federal Savings and Loan Insurance Corporation (FSLIC), which provides deposit insurance for savings and loan associations, was established in 1934. One year earlier, the Federal Deposit Insurance Corporation (FDIC) had been established to provide deposit insurance for commercial banks and for many mutual savings banks.

3. In 1980, 66 percent of all households were owners, although by 1982 this figure fell for the first time in decades to 65 percent. Over the years, rising household incomes also played a major role in enabling so large a proportion of households to become owners.

4. Since 1970, the estimated annual revenue loss from all homeownership tax incentives has risen to nearly $40 billion in fiscal year 1983, partly because of rising mortgage interest rates.